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In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 1005

REEF CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

The principal issue presented by this tax case is whether the transfer of assets from one corporation (Old Reef) to a newly formed corporation (New Reef), all the stock of which is owned by the majority stockholders of the old corporation, constitutes a reorganization within the meaning of 1954 Code § 368.

All the stock of Old Reef (a Texas corporation) was owned by two groups of stockholders: the Butler group which operated the company owned approximately 52 percent; the Favrot group which was comprised mainly of investors owned 48 percent. In 1958, the Butler group decided to have the corporation buy out the Favrot group for $2,920,800 in cash and notes, and a complicated plan was formulated

involving an intermediary (the Strong trust), a new corporate charter, and two sets of notes in identical face amounts. The details of the plan are set out in the opinions of the Tax Court (R. 239–254) and the court below (Pet. 33–34). In brief, the Butler group organized New Reef (a Delaware corporation) and became the owners of all its stock. Then both the Butler and Favrot groups sold their stock in Old Reef to the Strong trust, the Favrot group receiving $2,920,800 in cash and notes and the Butler group $2,624,400 in notes (the Butler group already having received all of the stock of New Reef). Simultaneously, Old Reef sold its operating assets to New Reef for notes in identical face amounts to those issued by the Strong trust. Old Reef was then liquidated and the Strong trust (its sole shareholder) received cash and notes equal to the cash and notes it had paid for Old Reef's stock. The trust immediately pledged the notes received from New Reef to secure the notes issued to the Butler and Favrot groups and, in accordance with the terms of its original notes, the trust was thereby relieved of all personal liability for payment of either interest or principal. (R. 243–254; Pet. 33–34.)[1]

The net result of this complex series of steps was as follows: The business which had been operated by Old Reef continued without interruption under a new corporate charter (New Reef) with the same management, employees and customers. The Butler

[1] "R." references are the printed record in the court of appeals.

group's ownership in the corporate enterprise was increased from 52 percent to 100 percent, while the Favrot group's 48 percent ownership was completely redeemed.

New Reef now claims that because of this change (1) its basis for depreciation in the assets received from Old Reef has been stepped-up so that the assets' basis is now $3,828,860 higher than it had been in the hands of Old Reef; (2) it is entitled to deduct, as "interest," payments on the notes issued to the Butler group (New Reef's sole shareholders) and held by them in exactly the same proportions as their stock ownership; and (3) Old Reef's taxable year terminated at the time of the transaction. (R. 253, 256–257.)

The Tax Court held that the transaction constituted a "D" (although not an "F") reorganization, so that Old Reef's basis in its assets carried over to New Reef. It also found that the notes of New Reef which were held by the Butler group of shareholders in proportion to their stockholdings actually represented equity capital rather than indebtedness, so that New Reef was not entitled to "interest" deductions for payments on those notes.[2] (R. 281–287.) The court of appeals sustained the Tax Court's holding that a "D" reorganization had occurred (Pet. 37–42) and that New Reef was not entitled to the claimed interest deductions (Pet. 32–44). It also held that the transfer

[2] No issue was raised with respect to the interest paid on the notes issued to the Favrot group, which owned no stock in New Reef.

of assets constituted an "F" reorganization, so that Old Reef's taxable year did not end at the time of the transaction. On this point, the court noted that distilling the "intricate and confusing facts of this case * * * to their pure substance, two distinct and unrelated events transpired. First, [the Favrot group which owned] 48% of the stock in [Old Reef] had their stockholdings completely redeemed. Second, New Reef was formed and the assets of [Old Reef] were transferred to New Reef" in an "F" reorganization (Pet. 46).

The decision below is correct. There is no conflict of decisions or other reason for further review by this Court.

1. *The "D" reorganization issue.*—In general, if substantially all the assets of a corporation (here Old Reef) are transferred to a new corporation (here New Reef) which is controlled by the transferor corporation or one or more of its stockholders, the transaction constitutes a "D" reorganization. 1954 Code §§ 368(a)(1)(D), 354(b). In such a case, the assets transferred have the same basis for depreciation in the hands of the new corporation (New Reef) as they did to the old corporation (Old Reef). 1954 Code § 362(b). Petitioner argues, however, that, even though Old Reef's business continued uninterrupted in the new corporate shell (New Reef), the instant transaction nevertheless does not constitute a "D" reorganization and that it should be allowed to increase the assets' basis for depreciation by more than $3,800,000.

(a) Petitioner first contends (Pet. 11–15) that the shareholders of Old Reef immediately before the transaction did not control New Reef immediately after the transaction. They argue that the Butler and Favrot groups had sold their stock in Old Reef to the Strong trust before the transfer of assets took place and that the trust independently decided to have Old Reef sell its assets to New Reef. As both lower courts held, the Strong trust acted merely as a conduit (Pet. 31–37, 41; R. 272). Pursuant to a prearranged plan the trust (1) purchased all the stock of Old Reef from the Butler and Favrot groups, (2) had Old Reef sell its operating assets to New Reef (which was wholly owned by the Butler Group), and (3) liquidated Old Reef, receiving cash and notes precisely equal to the price it had paid for Old Reef's stock. At most the trust held title to the Old Reef stock for only a short period while the preconceived plan was carried out. Therefore, the lower courts correctly held that immediately before the transaction began Old Reef's stock was owned by the Butler (52%) and Favrot (48%) groups, so that one or more of Old Reef's shareholders (the Butler group) not only controlled New Reef, but owned 100 percent of its stock. See, *e.g.*, *Helvering* v. *Alabama Asphaltic Limestone Co.*, 315 U.S. 179, 184–185; *Minnesota Tea Co.* v. *Helvering*, 302 U.S. 609, 613–614.

(b) Petitioner next contends (Pet. 15–22) that the transfer of assets from Old Reef to New Reef constituted a sale rather than a reorganization because Old Reef received notes rather than New Reef stock in ex-

change for its assets. The courts, however, have long rejected such formalistic arguments and held that whenever one corporation transfers its essential business enterprise to another corporation *which is controlled by one or more of the transferor corporation's stockholders*, the transaction constitutes a "D" reorganization, regardless of the form in which the transaction is cast. See, *e.g.*, *Lewis* v. *Commissioner*, 176 F. 2d 646 (C.A. 1); *Love* v. *Commissioner*, 113 F. 2d 236 (C.A. 3); *Bard-Parker Co.* v. *Commissioner*, 218 F. 2d 52 (C.A. 2), certiorari denied, 349 U.S. 906; *Liddon* v. *Commissioner*, 230 F. 2d 304 (C.A. 6), certiorari denied, 352 U.S. 824; *Commissioner* v. *Morgan*, 288 F. 2d 676 (C.A. 3), certiorari denied, 368 U.S. 836; *Moffatt* v. *Commissioner*, 363 F. 2d 262 (C.A. 9), petition for writ of certiorari pending, No. 804, this Term; *Davant* v. *Commissioner*, 366 F. 2d 874 (C.A. 5), petition for certiorari pending, No. 911, this Term; *Babcock* v. *Phillips* (C.A. 10), decided January 27, 1967, petition for writ of certiorari pending, No. 1215, this Term.

Petitioner argues that no "D" reorganization could have taken place unless New Reef transferred some of its stock to Old Reef in consideration for the latter's assets. Both lower courts held that the $2,624,400 in New Reef's subordinated notes issued to the Butler group in exact proportion to their stockholdings in New Reef constituted "risk capital" and actually represented an equity investment (Pet. 42–44; R. 282–287). Thus, a substantial part of the consideration which New Reef paid for Old Reef's assets

consisted of New Reef's "stock." And, as required by § 354(b)(1), Old Reef distributed all of the stock and securities which it received from New Reef. Thus, even under petitioners argument—that the transferee (New Reef) must give the transferor (Old Reef) some of the former's stock in part payment for the latter's assets—the instant transaction qualifies as a "D" reorganization. Moreover, as discussed at greater length in our Brief in Opposition to Certiorari in *Davant* v. *Commissioner*, No. 911, this Term (pp. 5–7), all of the lower courts which have passed on the question have concluded that, in cases like the instant one, the new corporation need not transfer any stock to the old corporation in part payment for its assets, if one or more of the old corporation's stockholders already own all the stock of the new corporation.[3]

[3] Since the Butler group, which owned the majority of Old Reef's stock, already owned 100 percent of New Reef's stock, it made no difference to them whether New Reef paid for Old Reef's assets in part by issuing some of its own stock; this would merely have increased the number of shares of Old Reef's common stock which they owned, but would not have effected any substantive change in their ownership. "To require the actual transfer of stock certificates where such a transfer would be a meaningless gesture would be to make the reorganization provisions optional with the taxpayer, a result which Congress clearly did not intend." *Davant* v. *Commissioner*, *supra*, p. 887. Accord: *Liddon* v. *Commissioner*, *supra*; *Commissioner* v. *Morgan*, *supra*; *Heller* v. *Commissioner*, 2 T.C. 371, affirmed, 147 F. 2d 376 (C.A. 9), certiorari denied, 325 U.S. 868; *Moffatt* v. *Commissioner*, *supra*; *Babcock* v. *Phillips*, *supra*.

Moreover, contrary to petitioner's contentions (Pet. 19), neither the result reached by the court of appeals nor its

2. *Deductibility of the "Interest" payments.*—The lower courts also correctly concluded that the so-called interest paid on the New Reef notes which were issued to the Butler group was not deductible as "interest * * * on indebtedness." Both lower courts concluded that these notes did not represent true "indebtedness" but were part of the risk capital invested by the Butler group in New Reef (Pet. 42–44; R. 282–287). This holding is essentially one of fact, depending on all the relevant circumstances.[4] Without seeking to discuss fully all of the factors taken into account by the courts below we note that all the notes were held by the stockholders of New Reef in proportion to their stock investment; all were subordi-

reasoning is in conflict with cases like *Pinellas Ice Co.* v. *Commissioner*, 287 U.S. 462; *LeTulle* v. *Scofield*, 308 U.S. 415, and *Cortland Specialty Co.* v. *Commissioner*, 60 F. 2d 937 (C.A. 2), certiorari denied, 288 U.S. 599. In those cases a corporation transferred its assets to another corporation in exchange for cash and short term notes, and the stockholders of the transferor corporation did not own any stock in the transferee. Thus the courts held that such a transaction did not constitute a reorganization because the "continuity of interest" requirement was not met, *i.e.*, the stockholders of the transferor corporation had no continuing equity interest in the transferee. See also *Helvering* v. *Watts*, 296 U.S. 387. In the instant case, however, the "continuity of interest" requirement was clearly satisfied, since one or more of Old Reef's stockholders owned all the stock of New Reef.

[4] See, *e.g.*, *John Kelley Co.* v. *Commissioner*, 326 U.S. 521; *Gilbert* v. *Commissioner*, 262 F. 2d 512 (C.A. 2), certiorari denied, 359 U.S. 1002; *Gooding Amusement Co.* v. *Commissioner*, 236 F. 2d 159 (C.A. 6), certiorari denied, 352 U.S. 1031; *Montclair, Inc.* v. *Commissioner*, 318 F. 2d 38 (C.A. 5); *Arlington Park Jockey Club* v. *Sauber*, 262 F. 2d 902 (C.A. 7); *O. H. Kruse Grain & Milling* v. *Commissioner*, 279 F. 2d 123 (C.A. 9).

nated to the claims of the life insurance loan used to redeem the stock of the Favort group; they were issued for assets essential to the business; and by their terms payment of both principal and interest was dependent on future earnings, the court of appeals estimating that the serial payments on the notes would not even begin until approximately seven years after the transaction. Thus, contrary to petitioner's contentions (Pet. 22–25), the concurrent findings of the courts below are amply supported by the record, and are entitled to finality here. See *Corn Products Co.* v. *Commissioner,* 350 U.S. 46; *Comstock* v. *Group of Investors,* 335 U.S. 211, 214.[5]

3. *The "F" reorganization issue.*—The third principal issue in this case is whether the transaction constitutes an "F" reorganization—*i.e.,* "a mere change in identity, form, or place of organization, however effected." 1954 Code § 368(a)(1)(F). Even though, as discussed *supra,* pp. 4–7, the transaction constitutes a "D" reorganization, it is nevertheless necessary to decide whether it also qualifies as an "F" reorganization. Although most of the important tax questions (such as carry-over basis for the assets) are settled by a determination that the transaction is a "D" reorganization, the question of whether the new and

[5] Petitioner argues that this holding conflicts with cases like *Pinellas Ice* and *LeTulle* (Pet. 23). As discussed, *supra,* fn. 3, pp. 7–8, those cases involve far different fact situations. In those cases the recipients of the new corporation's notes did not own any stock in that corporation and thus there was no claim, as there is here, that notes of the new corporation held pro rata by the shareholders of the new corporation really represent disguised equity capital.

old corporations are sufficiently distinct so that the old company should file a tax return for the partial taxable year ending with the reorganization and the new corporation file a separate tax return beginning with the date of the reorganization turns on whether the transaction qualifies as an "F" as well as a "D". Code § 381, which was enacted for the first time in 1954, makes it clear that when an "F" reorganization takes place, the old corporation does not file a separate income tax return for a portion of a year ending on the date of the reorganization but that the new corporation is regarded as a continuation of the old. However, if the reorganization does not qualify as an "F", the old corporation's taxable year ends on the date of the reorganization and the new corporation files a separate return beginning on that date. 1954 Code § 381(b).

The instant transaction took place during Old Reef's fiscal year beginning July 1, 1958. The court of appeals held that the transaction constituted an "F" reorganization as well as a "D" so that the two corporations should have filed a single return for the period July 1, 1958, to June 30, 1959. That court correctly looked through the form of the instant transaction and observed (Pet. 46, 52–53):

> Distilled to their pure substance, two distinct and unrelated events transpired. First, the holders of 48% of the stock in [Old] Reef [redacted] had their stockholdings completely redeemed. Second, new Reef was formed and the assets of [Old] Reef were transferred to new Reef. The business enterprise continued with-

> out interruption during both the redemption and the change in corporate vehicles.
>
> Much confusion flows from the fact that the corporate reorganization took place simultaneously with the stock redemption. But taking the Code as a standard, these two elements were functionally unrelated. [Old] Reef could have completely redeemed the stock of 48% of its shareholders without changing the state of its incorporation. * * *
>
> * * * * * *
>
> If a corporation did no more than completely redeem the stock interest belonging to 48% of its shareholders, it could not under the Code make wholesale accounting method changes. Likewise, if a corporation did no more than change its name and state of incorporation, it could not under the Code make wholesale accounting method changes. Combining these two events, neither of which would be sufficient alone, will not permit a corporation to make wholesale accounting method changes. Nothing in the Internal Revenue Code of 1954 contemplates such a result.

This holding is in accord with the statutory scheme and the underlying purpose of the Code, and is consistent with the decisions of this and other courts. Since neither a redemption nor a change in the state of incorporation standing alone would permit a corporation to change its taxable year or accounting methods, a corporation should not be able to produce a different tax result by merely combining the two. Although the redemption and the reincorporation were executed at the same time, they were not func-

tionally related. Cf. *Bazley* v. *Commissioner*, 331 U.S. 737, 742; *Minnesota Tea Co.* v. *Helvering*, 302 U.S. 609, 613.

Petitioner asserts conflict with *Helvering* v. *Southwest Consolidated Corp.*, 315 U.S. 194, wherein this Court held (pp. 202–203) that an "F" reorganization had not occurred because of the substantial change in the proprietary interest in the transferor and transferee corporations. But, viewing this case as involving two functionally unrelated events—a redemption by Old Reef of the Favrot group's 48 percent interest and then a change in the state of incorporation—as did the court of appeals, the Butler group owned all of Old Reef's stock before the reincorporation and all of New Reef's stock after. In *Southwest Consolidated*, on the other hand, there was a complete change in stock ownership between the new and the old corporations, *i.e.*, the shareholders of the old corporation owned none of the stock of the new corporation. Finally, even if *Southwest Consolidated* were not completely distinguishable from the instant case, the significant changes made in the Internal Revenue Code of 1954—such as the enactment of § 381, which was designed to prevent a corporation from "escap[ing] the tax consequences of the law [relating to carryover of accounting methods] by means of a legal artifice," such as combining a redemption with a change in the state of incorporation (H. Rep. No. 1337, 83d

Cong., 2d Sess., p. 41—might render the *Southwest* decision inapposite.[6]

The petition for a writ of certiorari should be denied.[7]

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[6] Nor does the instant decision conflict, as petitioner argues (Pet. 26–27), with *Columbia Gas of Maryland, Inc.* v. *United States*, 366 F. 2d 991 (Ct. Cl.) and *Cabot Corp.* v. *United States*, 220 F. Supp. 261 (D. Mass.), affirmed *per curiam*, 326 F. 2d 753 (C.A. 1). Both of those cases dealt with the excise tax which is imposed on the issuance and transfer of stock and securities and the exception for a transaction which is "a mere change in identity, form, or place of organization." Code § 4382(b)(1)(D). The Court of Claims explicitly recognized that because of the legislative history and administrative practice, this excise tax exception may well be narrower than the income tax "F" reorganization provision which is here in question. *Columbia Gas*, *supra*, p. 995. Moreover, both of those cases involved transactions which are far different than the instant case. *Columbia Gas* involved a divisive reorganization in which one corporation was split up into two separate businesses. *Cabot* involved a consolidation of four separate corporations into one. Thus neither case is apposite here, where a single corporation's business was transferred to a single new corporation organized in a different state. See also fn. 6, p. 11, of our Brief in Opposition in *Davant* v. *Commissioner*, No. 911, this Term.

[7] As a protective device, the Commissioner issued two deficiency notices which were intended to be in the alternative: one, based on the theory that the transaction constituted an "F" reorganization, covered a full taxable year; the other, based on the theory that the transaction constituted only a "D" reorganization, covered a short taxable year. Since the Tax Court held the transaction to be a "D" reorganization but not an "F", it upheld the deficiency notice for the short period. The court of appeal's conclusion that the transaction was an "F" validates the full-year deficiency notice. Thus the court of appeals should have remanded the portion of the case dealing with the short-period deficiency notice so the Tax Court could dismiss that part of the case. Instead it affirmed as to the short period

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APRIL 1967.

(petitioner's appeal) and remanded only as to the full year deficiency notice (the government's appeal) (Pet. 56). Thus, as petitioner points out (Pet. 28–29), there are presently two overlapping deficiency notices outstanding against it. However, there is no substance to petitioner's suggestion that the decision below may subject it to two assessments. The Commissioner will, upon disposition of this petition, join with petitioner in asking the court of appeals to order a remand of the entire case, which will permit the Tax Court to reassume jurisdiction with respect to the deficiency notice covering the short period and dismiss it from the case.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 163. INTEREST.

(a) *General Rule.*—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

* * * * * *

SEC. 354. EXCHANGES OF STOCK AND SECURITIES IN CERTAIN REORGANIZATIONS.

(a) *General Rule.*—

(1) *In general.*—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

* * * * * *

(b) *Exception.*—

(1) *In general.*—Subsection (a) shall not apply to an exchange in pursuance of a plan of reorganization within the meaning of section 368(a)(1)(D), unless—

(A) the corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets; and

(B) the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.

* * * * * *

SEC. 362. BASIS TO CORPORATIONS.

* * * * * *

(b) *Transfers to Corporations.*—If property was acquired by a corporation in connection

with a reorganization to which this part applies, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer. This subsection shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer.

* * * * *

SEC. 368. DEFINITIONS RELATING TO CORPORATE REORGANIZATIONS.

(a) *Reorganization.*—

(1) *In general.*—For purposes of parts I and II and this part, the term "reorganization" means—

* * * * *

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356;

* * * * *

(F) a mere change in identity, form, or place of organization, however effected.

* * * * *

(c) *Control.*—For purposes of part I (other than section 304), part II, and this part, the term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock en-

titled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

SEC. 381. CARRYOVERS IN CERTAIN CORPORATE ACQUISITIONS.

(a) *General Rule.*—In the case of the acquisition of assets of a corporation by another corporation—

(1) in a distribution to such other corporation to which section 332 (relating to liquidations of subsidiaries) applies, except in a case in which the basis of the assets distributed is determined under section 334(b)(2); or

(2) in a transfer to which section 361 (relating to nonrecognition of gain or loss to corporations) applies, but only if the transfer is in connection with a reorganization described in subparagraph (A), (C), (D) (but only if the requirements of subparagraphs (A) and (B) of section 354(b)(1) are met, or (F) of section 368(a)(1),

the acquiring corporation shall succeed to and take into account, as of the close of the day of distribution or transfer, the items described in subsection (c) of the distributor or transferor corporation, subject to the conditions and limitations specified in subsections (b) and (c).

(b) *Operating Rules.*—Except in the case of an acquisition in connection with a reorganization described in subparagraph (F) of section 368(a)(1)—

(1) The taxable year of the distributor or transferor corporation shall end on the date of distribution or transfer.

(2) For purposes of this section, the date of distribution or transfer shall be the day on which the distribution or transfer is completed; except that, under regulations prescribed by the Secretary or his delegate, the date when substantially all of the property has been distributed or transferred may be used if the

distributor or transferor corporation ceases all operations, other than liquidating activities, after such date.

(3) The corporation acquiring property in a distribution or transfer described in subsection (a) shall not be entitled to carry back a net operating loss for a taxable year ending after the date of distribution or transfer to a taxable year of the distributor or transferor corporation.

* * * * *

U.S. GOVERNMENT PRINTING OFFICE: 1967